
November 12, 2010

Municipal Bond Market Shudders

By MARY WILLIAMS WALSH

Has the reckoning arrived for municipal bonds?

That is the question investors are asking after munis — those old faithfuls of investing — took their biggest hit since the financial collapse of 2008.

Concern over the increasingly strained finances of states and cities and a growing backlog of new bonds for sale overwhelmed the market last week. After performing so well for so long, munis and funds that invest in them fell hard. One big muni fund, the Pimco Municipal Income Fund II, for instance, lost 7.5 percent. The fund is still up 6.75 percent so far this year.

While the declines were relatively small given the remarkable gains in these bonds over the last two years, the slump was swift enough to leave investors wondering if this was a brief setback or the start of something worse. For months, some on Wall Street have warned that indebted states and cities might face a crisis akin to the one that brought Greece to its knees.

“I think it’s too early to say that it’s more than a correction,” said Richard A. Ciccarone, the chief research officer of McDonnell Investment Management.

“The facts just don’t support a serious conclusion that the whole market’s going downhill,” he said.

"They could. We've got some serious liabilities out there."

The causes of the week's big decline are clouded by unusual factors like the looming end of the Build America Bonds program, which has prompted local governments to race new bonds to market before an attractive federal subsidy is reduced.

But the big question confronting this market is how state and local governments will manage their debts. Many are staggering under huge pension and health care obligations that seem unsustainable.

Certainties are impossible because governments do not have to disclose the pension payouts they will have to make in the coming years, as they do for bond payouts.

California, for example, will have to sell nearly $14 billion of debt into the falling market this month, because of its record delay in getting a budget signed this year. The warnings keep coming. On Friday, Fitch, the credit ratings agency, issued a report saying that ratings downgrades for municipal bonds outnumbered upgrades for the seventh consecutive quarter.

And a few prominent defaults have made the market jittery.

"This is what happens with our market now, with these fears of a systemic credit crisis," said Matt Fabian, managing director at Municipal Market Advisors. "Any weakness is related to fears of default."

Standard & Poor's, meanwhile, issued a report last Monday observing that even troubled cities like Detroit were still able to bring debt to market at what the rating agency considered favorable rates. It said most government officials seemed determined to honor their general obligations.

Analysts like Mr. Ciccarone said much of the decline was concentrated among longer-maturity bonds and bonds with lower credit ratings. Their values fell more sharply as investors watched the Federal Reserve buying hundreds of billions of dollars of Treasury bonds and concluded the Fed's move would be inflationary over the longer term. That made some investors less willing to hold long-term municipal bonds, so the prices of the bonds fell.

Until two weeks ago, the municipal bond markets had been frothy, thanks in part to the intensifying interest of wealthy individuals in tax-sheltered investments as the sunset date on the Bush administration's tax cuts looms. People seek a tax shelter like municipal bonds because the interest is usually not taxed, and the bonds are considered very safe.

This year, however, tax-exempt municipal bonds have been harder than usual to find, because the governments that normally issue them have switched over to taxable bonds.

So investors were bidding up the prices. Mr. Fabian said that had fed into the prices of all of the municipal bonds held by mutual funds, which are assigned a value each day on the basis of a model because they may not trade.

The reason for scarcity of tax-exempt bonds has been, in part, the Build America Bonds program, created as part of the fiscal stimulus program. That federally subsidized program is scheduled to expire at the end of this year, so states and cities have been rushing to take advantage of it.

Yet the values of tax-exempt munis fell, defying those who said it was all a matter of supply and demand. The last week also brought some large tax-exempt bond issues, including one by a public authority in Massachusetts for Harvard University, which was reduced because of poor investor demand.

Mr. Fabian said the downdraft could continue next week.

"The risk is that you don't know," he said.

"You have an awful lot of money, including from households, that simply follows momentum."

This article has been revised to reflect the following correction:

Correction: November 13, 2010

An earlier version of a photo caption with this article incorrectly described the status of $14 *billion worth of California's debt. It will have to be sold, it has not yet been sold.*